

Section 12

The 2005 IRS “Dirty Dozen” Abusive Tax Avoidance Transactions

The Internal Revenue Service’s annual listing (IR-2005-19) of notorious tax scams, the “Dirty Dozen,” reminds taxpayers to be wary of schemes that promise to eliminate taxes or otherwise sound too good to be true.

The “Dirty Dozen” for 2005 includes several new scams that either manipulates laws governing charitable groups, abuse credit counseling services or rely on refuted arguments to claim tax exemptions. The agency also sees the continuing spread of identity theft schemes preying on people through e-mail, the Internet or the phone, sometimes with con artists posing as representatives of the IRS.

“The Dirty Dozen is a reminder that tax scams can take many forms,” IRS Commissioner Mark W. Everson said. “Don’t be fooled by false promises peddled by scam artists. They’ll take your money and leave you with a hefty tax bill.”

Involvement with tax schemes can lead to imprisonment and fines. The IRS routinely pursues and shuts down promoters of these scams. But taxpayers should also remember that anyone pulled into these schemes could face repayment of taxes plus interest and penalties.

Persons who suspect tax fraud can call the IRS at 1-800-829-0433.

The Dirty Dozen

The IRS urges people to avoid these common schemes:

1. **Trust Misuse.** Unscrupulous promoters for years have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, some trusts do not deliver the promised tax benefits, and the IRS is actively examining these arrangements. More than two dozen injunctions have been obtained against promoters since 2001, and numerous promoters and their clients have been prosecuted. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.
2. **Frivolous Arguments.** Promoters have been known to make the following outlandish claims: that the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; that wages are not income; that filing a return and paying taxes are merely voluntary; and that being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy.

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Don't believe these or other similar claims. Such arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law.

3. **Return Preparer Fraud.** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their ploys. Such preparers derive financial gain by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Taxpayers should choose carefully when hiring a tax preparer. As the saying goes, if it sounds too good to be true, it probably is. No matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. Since 2002, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others, which are pending in court.
4. **Credit Counseling Agencies.** Taxpayers should be careful with credit counseling organizations that claim they can fix credit ratings, push debt payment agreements or charge high fees, monthly service charges or mandatory “contributions” that may add to debt. The IRS Tax Exempt and Government Entities Division has made auditing credit counseling organizations a priority because some of these tax-exempt organizations, which are intended to provide education to low-income customers with debt problems, are charging debtors large fees, while providing little or no counseling
5. **"Claim of Right" Doctrine.** In this scheme, a taxpayer files a return and attempts to take a deduction equal to the entire amount of his or her wages. The promoter advises the taxpayer to label the deduction as “a necessary expense for the production of income” or “compensation for personal services actually rendered.” This so-called deduction is based on a misinterpretation of the Internal Revenue Code and has no basis in law.
6. **“No Gain” Deduction.** Similar to “Claim of Right,” filers attempt to eliminate their entire adjusted gross income (AGI) by deducting it on Schedule A. The filer lists his or her AGI under the Schedule A section labeled “Other Miscellaneous Deductions” and attaches a statement to the return, referring to court documents and including the words “No Gain Realized.”
7. **Corporation Sale.** Since September 2004, the Department of Justice has obtained six injunctions against promoters of this scheme and filed complaints against 11 others.

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Participants apply for incorporation under the pretext of being a “bishop” or “overseer” of a one-person, phony religious organization or society with the idea that this entitles the individual to exemption from federal income taxes as a nonprofit, religious organization.

When used as intended, Corporation Sole statutes enable religious leaders to separate themselves legally from the control and ownership of church assets. But the rules have been twisted at seminars where taxpayers are charged fees of \$1,000 or more and incorrectly told that Corporation Sole laws provide a “legal” way to escape paying federal income taxes, child support and other personal debts.

8. **Identity Theft.** It pays to be choosy when it comes to disclosing personal information. Identity thieves have used stolen personal data to access financial accounts, run up charges on credit cards and apply for new loans. The IRS is aware of several identity theft scams involving taxes. In one case, fraudsters sent bank customers fictitious correspondence and IRS forms in an attempt to trick them into disclosing their personal financial data. In another, abusive tax preparers used clients’ Social Security numbers and other information to file false tax returns without the clients’ knowledge. Sometimes scammers pose as the IRS itself. Last year the IRS shut down a scheme in which perpetrators used e-mail to announce to unsuspecting taxpayers that they were “under audit” and could set matters right by divulging sensitive financial information on an official-looking Web site. Taxpayers should note the IRS does not use e-mail to contact them about issues related to their accounts. If taxpayers have any doubt whether a contact from the IRS is authentic, they can call 1-800-829-1040 to confirm it.
9. **Abuse of Charitable Organizations and Deductions.** The IRS has observed an increase in the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur, for example, when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income, thereby obtaining a tax deduction without transferring a commensurate benefit to charity. A “contribution” of a historic facade easement to a tax-exempt conservation organization is another example. In many cases, local historic preservation laws already prohibit alteration of the home’s facade, making the contributed easement superfluous. Even if the facade *could* be altered, the deduction claimed for the easement contribution may far exceed the easement’s impact on the value of the property.

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10. **Offshore Transactions.** Despite a crackdown on the practice by the IRS and state tax agencies, individuals continue to try to avoid U.S. taxes by illegally hiding income in offshore bank and brokerage accounts or using offshore credit cards, wire transfers, foreign trusts, employee leasing schemes, private annuities or life insurance to do so. The IRS, along with the tax agencies of U.S. states and possessions, continues to aggressively pursue taxpayers and promoters involved in such abusive transactions.
11. **Zero Return.** Promoters instruct taxpayers to enter all zeros on their federal income tax filings. In a twist on this scheme, filers enter zero income, report their withholding and then write “nunc pro tunc”—Latin for “now for then”—on the return.
12. **Employment Tax Evasion.** The IRS has seen a number of illegal schemes that instruct employers not to withhold federal income tax or other employment taxes from wages paid to their employees. Such advice is based on an incorrect interpretation of Section 861 and other parts of the tax law and has been refuted in court. Recent cases have resulted in criminal convictions, and the courts have issued injunctions against more than a dozen persons ordering them to stop promoting the scheme. Employer participants can also be held responsible for back payments of employment taxes, plus penalties and interest. It is worth noting that employees who have nothing withheld from their wages are still responsible for payment of their personal taxes.

Other Scams Still Linger

The IRS removed four scams from the Dirty Dozen this year: slavery reparations, improper home-based businesses, the Americans with Disabilities Act and EITC dependent sharing. The agency has noticed declines in activity in some of these schemes. But taxpayers should remain wary because the IRS has seen old scams resurface or evolve.

Moreover, the IRS reminds taxpayers to be vigilant about cons that may not be on the Dirty Dozen list. New tax scams or schemes routinely pop up, especially around tax time.